

ANALYSIS OF ORIGINAL BILL

Author: Runner Analyst: Marion Mann DeJong Bill Number: AB 1779

Related Bills: See Legislative History Telephone: (916) 845-6979 Introduced Date: 02/06/98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Joint Strike Fighter Program Credits

SUMMARY

This bill would create a wage credit and property credit for the Joint Strike Fighter (JSF) program. These credits would apply to taxpayers under contract or subcontract to manufacture property for ultimate use in a JSF.

This bill also would declare legislative intent to better understand the relationship of directed tax credits to the creation of jobs in California and require the State Auditor to report to the Legislature regarding the number of taxpayers claiming the wage credit and the number of jobs directly attributable to the claimed credit.

EFFECTIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The bill specifies that the credit would apply to taxable or income years beginning on or after January 1, 1998, and before January 1, 2006.

LEGISLATIVE HISTORY

AB 390 (1997/98), AB 2361 (1995/96).

BACKGROUND

The JSF Program is the Department of Defense's focal point for defining "affordable next generation strike aircraft weapon systems" for the Navy, Air Force, Marines, United Kingdom Royal Navy and other U.S. allies. The focus of the program is affordability -- reducing the development cost, production cost, and cost of ownership of the JSF family of aircraft.

There are five phases to the program, the Concept Exploration Phase (completed), the Concept Development Phase (completed), the Concept Demonstration (fiscal years 1997 - 2000), the Engineering and Manufacturing Development Phase (fiscal years 2001 - 2007), and the Production Phase (fiscal years 2008 and after).

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO _____

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Gerald H. Goldberg

3/3/98

Agency Secretary

Date

By:

Date:

The Concept Exploration Phase concluded that a "family of aircraft" should be developed to meet tri-service needs. The "family of aircraft" concept would meld the operational and technological requirements of all armed services into highly common (up to 90% common) aircraft. Additional systems and components could be added to the common aircraft (aircraft variants) to satisfy unique service needs. A highly common aircraft should reduce manufacturing and assembly costs. In addition, it should extend the operational life of the aircraft.

The Concept Development Phase focused on (1) developing aircraft system designs that take advantage of the "family of aircraft" concept and (2) defining the necessary leveraging technology demonstrations that will lower risk prior to entering the Engineering and Manufacturing Development Phase.

The Concept Demonstration Phase commenced in fiscal year 1997 following a competitive elimination process from three weapon system concept teams to two. This phase will feature flying concept demonstrators, concept-unique ground and flight demonstrations, and continued refinement of the contractors' preferred weapon system concepts.

This phase is budgeted at \$2.2 billion, including propulsion efforts funded under a separate contract. The Boeing Company was awarded a \$662 million cost-plus-fixed-fee contract and Lockheed Martin Corporation was awarded a \$719 million cost-plus-fixed-fee contract. The Boeing Company contract is expected to be performed in Seattle, Washington. The Lockheed Martin Corporation contract is expected to be performed in Palmdale, California (71%), and Fort Worth, Texas (29%). Contracts also were awarded to Pratt and Whitney to provide hardware and engineering support for the Weapon System Concept Demonstration efforts and to General Electric for the propulsion.

The Engineering and Manufacturing Development Phase is planned for fiscal year 2001. The first delivery of operational aircraft is anticipated in fiscal year 2008. The Production Phase is planned for fiscal year 2008.

The U.S. armed forces will need as many as 3,000 JSFs to replace several different aircraft in service today. The potential export market for the JSF is estimated to be very large.

SPECIFIC FINDINGS

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or as investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business (e.g., employee wages and benefits).

Existing state law allows taxpayers to use various credits against tax such as the Manufacturers' Investment Credit (MIC) and economic development area sales or use tax credits and hiring credits.

Manufacturers' Investment Credit

The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California. A qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the SIC Manual. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code and used primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of manufacturing, refining, processing or fabricating, or research and storage facilities that are part of the process, which are used by qualified persons performing manufacturing activities described in specific codes relating to computer, accounting, and office machines, electronic equipment and accessories, biotech or biopharmaceutical activities, semiconductor equipment manufacturing activities and certain aerospace manufacturing activities.

The MIC explicitly excludes certain types of property from the definition of qualified property, including equipment used in the extraction process, furniture, facilities used for warehousing purposes after completion of the manufacturing process, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing.

The MIC provides a variety of special rules for costs paid pursuant to a binding contract and leased property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover period is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within

¹ Economic development areas include Enterprise Zones, the Los Angeles Revitalization Zone (LARZ), Local Agency Military Base Recovery Areas (LAMBRAs), Targeted Tax Areas (TTAs) and Manufacturing Enhancement Areas (MEAs).

one year from the date the property is first placed in service in California.

The MIC will become inoperative on January 1, 2001, or on January 1 of the earliest year after 2001 if the total employment in manufacturing in this state does not exceed by 100,000 jobs the total employment in manufacturing in this state on January 1, 1994. The Employment Development Department (EDD) is required to report to the Legislature annually on this determination.

Sales or Use Tax Credit

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property for exclusive use in an economic development area (except an MEA). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone:

- machinery and machinery parts used to:
 - manufacture, process, combine, or otherwise fabricate a product;
 - produce renewable energy resources; or
 - control air or water pollution.

LAMBRA:

- high technology equipment (e.g., computers);
- aircraft maintenance equipment;
- aircraft components; or
- certain depreciable property.

LARZ:

- building materials used to replace or repair the business's building and fixtures; and
- machinery or equipment, excluding inventory.

TTA:

- machinery and machinery parts used to:
 - manufacture, process, combine, or otherwise fabricate a product;
 - produce renewable energy resources;
 - control air or water pollution;
 - data process and communications; or
 - manufacture motion pictures.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the enterprise zone, LAMBRA, and TTA sales or use tax credit is \$1 million for individuals and \$20 million for corporations. No such limitation exists for the LARZ sales or use tax credit. If a taxpayer cannot use the full amount of credit allowable in any one year, the taxpayer may carryover the remainder of the credit for use in subsequent tax years, including those years after the designation has expired, until all of the credit is used.

Hiring Credits

A business located in an economic development area may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an economic development area and must meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the economic development area and at least 50% must be performed inside the economic development area.

The taxpayer may claim as a credit up to 50% of the wages paid to a qualified employee against tax imposed on economic development area income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (202% of the minimum wage for certain aircraft manufacturer employees within the Long Beach Enterprise Zone). The amount of the credit must be reduced by any other federal or state jobs tax credits and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

Certain criteria regarding who may be qualified employees and certain limitations differ between the various economic development areas. For the LARZ, an additional construction hiring credit is available: a taxpayer with a business located in a LARZ may claim as a credit against tax imposed on LARZ income 50% to 100% of the wages paid to a qualified construction employee. The actual percentage depends upon the date the employee was hired.

If a taxpayer cannot use the full amount of credit allowable in any one year, the taxpayer may carryover the remainder of the credit for use in subsequent tax years, including those years after the designation has expired, until all of the credit is used.

This bill would create a wage credit and a property credit for the JSF program. These credits would apply to taxpayers under contract or subcontract to manufacture property for ultimate use in a JSF. The credits would be available for taxable years beginning on or after January 1, 1998, and before January 1, 2006. Any excess credit could be carried forward for up to eight years. No credit would be allowed unless the credit was reflected in the bid upon which the JSF contract or subcontract is based. The taxpayer would be required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a JSF contract or subcontract.

The wage credit would be equal to a specified percentage (50% for 1998, 40% for 1999, 30% for 2000, 20% for 2001 and 10% for 2002 to 2005) of employee wages that are treated as direct costs under Section 263A of the Internal Revenue Code (IRC) allocable to property manufactured in this state for ultimate use in a JSF. The wages could be paid to new or existing employees whose services for the taxpayer are at least 90% directly related to the contract or subcontract to manufacture property for ultimate use in a JSF. The credit would be limited to \$10,000 per year, per employee, and be prorated for partial years.

The property credit is generally patterned after the MIC and is in addition to the MIC. It would be equal to 10% of the cost of qualified property. Qualified property would mean tangible personal property (IRC Section 1245(a)(3)(A)), and capitalized labor costs that are treated as direct costs under Section 263A of the IRC allocable to that property, used by a taxpayer primarily in activities to manufacture a product for ultimate use in a JSF.

Certain types of property would be excluded from the definition of qualified property, including furniture, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing. The bill would provide special rules for costs paid pursuant to a binding contract and leased property.

The credit would be recaptured if, within one year of being placed in service, the property is sold, moved out of state or used for purposes other than manufacturing a product for ultimate use in a JSF.

Policy Considerations

This bill would allow taxpayers to claim the JSF credits and any existing credits (e.g. MIC, sales or use tax credits and hiring credits) that the taxpayer is allowed that do not contain provisions restricting the taxpayer to one credit based upon a single investment or employee.

In addition, there is overlap between the wage credit and the qualified property credit in that capitalized labor costs that are treated as direct costs under Section 263A of the IRC would be eligible for both credits (plus any existing credits that do not contain provisions restricting the taxpayer to one credit based on a single investment or employee).

Implementation Considerations

Implementation of the provision of this bill would occur during the department's normal annual system update.

Technical Consideration

Amendments 1 and 5 would replace "the" with "any" to allow non-individual taxpayers to claim a credit when an intervening event (e.g., reorganization, partnership termination) forces the taxpayer to have more than one taxable or income year during a calendar year period.

Amendments 2, 3, 4, 6, 7 and 8 would change the term "passthrough" to "pass-through" to reflect the use of the term as an adjective or adverb.

LEGISLATIVELY MANDATED REPORTS

This bill would require the State Auditor to report to the Legislature on or before March 1, 2000, and each March 1 thereafter, regarding the number of taxpayers claiming the wage credit and the total number of jobs directly attributable to the claimed credit.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses for this bill over the initial three-year period are projected to be as follows:

Fiscal Year Cash Flow Impact Enactment Assumed After 6/30/98 \$ Millions			
	1998-99	1999-00	2000-01
Property	(1)	(3)	(8)
Wages	(3)	(8)	(18)
Total	(4)	(11)	(26)

Tax Revenue Discussion

This revenue estimate depends on the value of investment and wages paid in California as part of the JSF project. This estimate assumes that the credits could be claimed in the year in which the federal government disburses money under the JSF program and would be in addition to any other credits or deductions currently allowed for such expenditures. These credits would be available only for JSF contracts and subcontracts that specifically reflect the use of these credits in the bid.

The JSF program is currently in the concept demonstration phase. The federal government has budgeted \$2.2 billion for this phase of the project. Expenditures were assigned to specific years in proportion to the total budget outlay for each year (*JSF Program's home page*). The Department of Defense (DOD) has already awarded two contracts as part of this phase of the project -- \$662 million to Boeing and \$719 million to Lockheed Martin (*Defense Department Press Releases 11/96*). Lockheed Martin has indicated that it intends to perform 71% of the contract in California (*DOD Press Release*). This estimate assumes that 71% of the work performed under the Lockheed Martin contract and 20% of the work performed under all other demonstration phase contracts are located in California.

This estimate assumes the following:

- 10% of qualifying expenditures in 1998 would be attributable to subcontracts that reflect the use of these credits in the bid. This percentage is assumed to rise to 30% in 1999 and 50% in 2000. These credits would also apply to the engineering and manufacturing development phase of the JSF project scheduled to begin in 2000.
- 40% of all JSF contracts would be spent on qualified investments.

- 40% of all JSF contracts would be spent on wages of qualified employees. In addition, 40% of subcontracts for qualified investments will be spent on wages of qualified employees. However, since the credit is limited to \$10,000 per employee, it is estimated that the wage credit would be approximately 25% of total wages in 1998. As the structure of the credit changes, credit as a percentage of total wages declines to just under 10% by 2002.
- 60% of credits would be used in the year in which they are generated. The numbers in the table reflect credits used.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1779
As Introduced February 6, 1998

AMENDMENT 1

On page 2, modify lines 8 through 19 as follows:

(1) Fifty percent of qualified wages paid or incurred during~~the~~ any taxable year beginning on or after January 1, 1998, and before January 1, 1999.

(2) Forty percent of qualified wages paid or incurred during~~the~~ any taxable year beginning on or after January 1, 1999, and before January 1, 2000.

(3) Thirty percent of qualified wages paid or incurred during~~the~~ any taxable year beginning on or after January 1, 2000, and before January 1, 2001.

(4) Twenty percent of qualified wages paid or incurred during~~the~~ any taxable year beginning on or after January 1, 2001, and before January 1, 2002.

AMENDMENT 2

On page 2 lines 27 and 31, strikeout "passthrough" and insert:

pass-through

AMENDMENT 3

On page 3 line 4, strikeout "passthrough" and insert:

pass-through

AMENDMENT 4

On page 6 lines 8, 12 and 17, strikeout "passthrough" and insert:

pass-through

AMENDMENT 5

On page 12, modify lines 3 through 14 as follows:

(1) Fifty percent of qualified wages paid or incurred during~~the~~ any income year beginning on or after January 1, 1998, and before January 1, 1999.

(2) Forty percent of qualified wages paid or incurred during~~the~~ any income year beginning on or after January 1, 1999, and before January 1, 2000.

(3) Thirty percent of qualified wages paid or incurred during~~the~~ any income year beginning on or after January 1, 2000, and before January 1, 2001.

(4) Twenty percent of qualified wages paid or incurred during~~the~~ any income year beginning on or after January 1, 2001, and before January 1, 2002.

AMENDMENT 6

On page 12 lines 22, 26 and 30, strikeout "passthrough" and insert:

pass-through

AMENDMENT 7

On page 15 lines 33 and 37, strikeout "passthrough" and insert:

pass-through

AMENDMENT 8

On page 16 line 2, strikeout "passthrough" and insert:

pass-through